International Economics 137 (2014) 1–21

Contents lists available at ScienceDirect

International Economics

journal homepage: www.elsevier.com/locate/inteco

Real exchange rate and competitiveness of an EU's ultra-peripheral region: La Reunion Island

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ARTICLE INFO

Available online 1 November 2013

JEL Classification:
F14
F31
C22

Keywords:
Real exchange rate
Ultra-peripheral region
La Reunion
Competitiveness
Euro
Misalignment

ABSTRACT

This article aims at analyzing the problem of real exchange rate appreciation and competitiveness in the EU's ultra-peripheral regions by the case study of La Reunion Island. After describing economic characteristics of this French overseas department, such as the large deficit of the trade balance, this article looks for explanation by calculating and examining the statistical properties of the real effective exchange rate (REER). Our results show that this rate is stationary around a trend and provides evidence of (i) an appreciation of the REER, but (ii) no permanent overvaluation of the currency. These two results can be explained by the economic catch-up of La Reunion characterized by gains in relative productivity, and by the dynamics of the terms of trade and a permanent increase in the transfers from metropolis.

1. Introduction

The outermost regions of Europe, with more than 4 millions of inhabitants, represent a particular challenge for the European integration. Located in the Atlantic and Indian Oceans, in the Caribbean Sea and in South America, these regions are eloquently defined along remoteness, small size,

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http://dx.doi.org/10.1016/j.inteco.2013.10.005

economic dependency on a few products and insularity.[1] These ultra-peripheral regions are the four French overseas departments (Reunion, Guadeloupe, French Guyana and Martinique), two Portuguese autonomous regions (Azores and Madeira) and one Spanish autonomous community (Canary Islands).[2] The Euro is the official currency in these regions, which is problematic in term of competitiveness when exchange rate changes, driven by the overall situation of the Euro Zone, are disconnected from economic fundamentals in these islands. Actually, ultra-peripheral regions may face the same problem than some Southern European countries.

Obviously, overseas departments receive transfers from the metropolitan country that represent a major difference, but this advantage could fade away in a near future. Austerity and budget constraints in Europe will inevitably lead to a reduction in transfers and many politicians in ultra-peripheral regions fear to lose an important instrument of adjustment. With less transfers, economic conditions of development can deteriorate with increasing risks of instability and poverty. In this context, a strong Euro is devastating for exports but brings purchasing power on imports that characterized these regions. The current article focuses on La Reunion Island that is representative of many problems encounter by an ultra-peripheral region. Conclusions that can be drawn from our study may contribute to the debate on specialization and suboptimal monetary union.

Basic development indicators show that despite significant improvements, gaps between La Reunion and its metropolitan patron remain relatively large. Concerning the GDP per capita, according to INSEE [The French Statistical Office], the level of La Reunion represents only 37% and 59% of the national average in 1985 and 2008 respectively.[3] Furthermore these results are supported in all the three dimensions of the Human Development Index, health, education and standard of living (Goujon, 2008, 2009; Sudrie, 2012).The vulnerability of this small island is also pronounced in the external dimension (Candau et al., 2012). The export rate is particularly low, averaging 6% of GDP in 2005 and the ratio of exports to imports is stable around 6–7% only since the beginning of the 1990s. The current trade balance deficit increased continuously over the last three decades to exceed 25% of GDP in the late 2000s.

Such economic results would suggest a lack of competitiveness. In order to analyze such a possibility for La Reunion, we adopt in this article a medium run macroeconomic perspective. More precisely, we calculate a usual indicator in international economics, the Real Effective Exchange Rate (REER, Hinkle and Nsengiyumva, 1999) against the major trade partners over the last decades. We find that REER fluctuations result from changes in the nominal exchange rate but also from inflation rate differentials between La Reunion and its trade partners. Moreover, the REER shows an appreciation trend. This outcome should imply a loss in competitiveness if not caused by an improvement in fundamentals, as an increase in the relative productivity. So, we try to identify whether this appreciation trend is associated to an equilibrating or a disequilibrating movement.

In a first step, using quarterly data, we follow Kejriwal and Lopez (2013) and verify that there is no structural break in the REER series. Then, we can use a set of standard unit root tests (Dickey and Fuller, 1981; Phillips and Perron, 1988; Kwiatkowski et al., 1992; Elliott et al., 1996; Ng and Perron, 2001),which show that La Reunion's REER is stationary around a deterministic trend. In a second step, using annual data, we try to explain the appreciation trend by estimating an equation for REER's fundamentals. Results show that REER is driven by gains in productivity, terms of trade and public transfers.

In a third step, REER misalignments are computed as the gap between observed REER and the equilibrium REER defined as a simple deterministic trend or as the predicted REER from the equation of REER's fundamentals. Both methods detect similar phases of misalignments, and estimated misalignments are found to be small.

The rest of the paper is as follows. Section 2 gives several stylized facts about the structure of La Reunion's foreign trade and the catching up effect at work. Section 3 presents analytical elements of the REER. Section 4 reports computations of the bilateral and multilateral levels of the real exchange

[1] See Article 299 of the European Community Treaty.

[2] On 11 July 2012, the European Council recommended that Mayotte (French department in the Indian Ocean) take the status of an “ultra-peripheralregion” of the European Union as of 1 January 2014.

[3] 18,200 € against 30,700 € in 2008.